

# **Outsourcing in State and Local Governments: A Literature Review and a Report on Best Practices**

**Report for Nashville-Davidson County Metropolitan Government  
Office of Metropolitan Social Services**

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## **Outsourcing in State and Local Governments: A Literature Review and a Report on Best Practices**

### **Executive Summary**

Enlisting private companies to deliver a wide array of government products and services is now a common and accepted practice. Approximately 80 percent of all U.S. cities outsource some services, and we now have a long history of real world experiences at all levels of government from which some conclusions can be drawn. Metropolitan Government of Nashville and Davidson County's Office of Metropolitan Social Services contracted with the University of Tennessee's Center for Business and Economic Research to write a report on the use of outsourcing in state and local governments.

This report reviews the literature on the privatization of state and local government services with a focus on outsourcing or contracting out selected services to local private for-profit or nonprofit entities. We attempt to draw on the privatization experiences to date to get an idea of what functions are the best candidates for privatization, what benefits should be reasonably expected, and conclude with a discussion of best practices for a government contemplating a privatization program.

Efficiency gains from outsourcing result from free-market competition rather than whether a service is provided by the public or private sector. When a service required by government is put out for bid in the open market, many firms, and in many cases the incumbent government agency, compete for the business and therefore all have strong incentives to provide the best product at the lowest price. Therefore outsourcing works best when many qualified private firms are able to take on the government function. Not surprisingly, "hard" services such as road building, janitorial services, garbage collection, and turf maintenance are most commonly outsourced and produce predictably quality results and significant cost savings.

Many social services have few, if any, private counterparts, and outsourcing these functions is less likely to be successful. In addition, these services often

lack specific goals, and a single point of accountability, and information systems to track the service and outcome measures. In addition, improving social services often involves goals other than cost savings, such as increasing the expertise of personnel or improving service quality, and these goals are often difficult to measure.

The most successful privatization programs are highly organized. We focus on six common themes: (1) A political leader or small group of leaders to champion the effort, (2) a formal structure to guide implementation, (3) legislative changes and/or reductions in allocated resources to encourage change, (4) reliable cost data, (5) strategies to deal with work force transition, and (6) post-privatization monitoring and oversight.

A number of CBER researchers made significant contributions to this report. I appreciate the help of Julie Marshall, Beth Howard, Bryan Shone and Leighann Barnette for their research assistance. This project could not have been completed without their help.

A handwritten signature in black ink that reads "LeAnn Luna". The signature is written in a cursive, flowing style.

LeAnn Luna  
Assistant Professor and Project Director

## **Introduction**

Enlisting private companies to deliver a wide array of government products and services is now a common and accepted practice. Since privatization began in earnest in the 1970s, we now have a long history of real world experiences at all levels of government from which some conclusions can be drawn. This report reviews the extensive literature, both academic and non-academic, that addresses the many facets of privatization of government services. We address the following questions:

- What does outsourcing in government look like?
- What does outsourcing in social service arenas look like?
- What is the value added of outsourcing and how is it measured?
- What is the value added of outsourcing social services and how is it measured?
- What are the best practice guidelines for governments contemplating outsourcing one or more functions?

Privatization is defined as “any process aimed at shifting functions or responsibilities, in whole or in part, from the government to the private sector” (Segal, 2005).<sup>1</sup> Privatization can take many forms, including simple grants or subsidies to private entities, public-private partnerships, or complete divestiture of ownership and control of a government asset, such as a hospital or water treatment facility.<sup>2</sup> We focus in this report on outsourcing or contracting where the government retains significant control and oversight over the end product or service, determines a detailed set of performance standards, provides the funds, but enlists a private for-profit or non-profit entity to perform the service or provide the goods. This type of arrangement represents the vast majority of privatization efforts (See Table 1). Unless otherwise noted, privatization, outsourcing, and contracting are interchangeable terms for purposes of this report.

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<sup>1</sup> Peter Drucker (1969) is credited with providing the first definition of privatization.

<sup>2</sup> See Savas (2000) for a complete discussion of the various forms of privatization.

Outsourcing represents about 92 percent of the privatization efforts for administrative and general services agencies in 1993. Although not listed in Table 1 below, administrative and general service agencies also used vouchers (3 percent), public-private partnerships (2 percent) with all other privatization methods (including grants, volunteerism, franchising, and asset sales) each representing less than 1 percent of the survey respondents' privatization efforts.

**TABLE 1**  
**PERCENTAGE USE OF OUTSOURCING AS METHOD**  
**OF PRIVATIZATION FOR SELECTED AGENCIES**

AGENCY	1993	1997
Administration and General Services	91.7	86.7
Corrections	92.1	82.8
Education	81.3	92.5
Health	69.6	60.2
Mental Health & Retardation	64.7	82.7
Social Services	71.3	68.1
Transportation	83.5	91.0

Source: The Council of State Governments, 1993 and 1997.

### **What Does Outsourcing in Government Look Like?**

Governments at all levels have turned to private entities to deliver some services. In 1992, a survey sponsored by the National Institute of Comptrollers found that 90 percent of state government agencies use some form of privatization (David, 1992).<sup>3</sup> Most cities use some form of privatization and approximately 80 percent contracted out for some services (Miranda and Andersen, 1994). Also 85 percent of survey respondents felt that privatization would play a major role in the future decade of their agency. This number increased 35 percent from a study conducted only three years earlier. Surveys conducted by the Council of State Governments in 1997 and 2002 show that these predictions were correct (Table 2). From 1993 to 1997 state privatization increased close to 60 percent and from 1998 to 2002 it rose another 36 percent. Responses from budget directors of 12 states (Arizona, Connecticut, Indiana, Massachusetts, Minnesota, Missouri, North

<sup>3</sup> The survey was conducted by Apogee Research but sponsored by National Institute of Comptrollers.

Carolina, Oklahoma, Virginia, Washington, Wisconsin, and Wyoming) reveal that on average at least 6 percent of their services are privatized.

**TABLE 2**  
**TRENDS IN PRIVATIZATION, 1993-2002**

TREND	1993-1997	1998-2002
Increased	60.1	36.2
Remained the Same	26.2	52.8
No Privatization	12.3	4.0
No Response	1.2	2.0
Decreased	0.2	5.0

Source: Survey of directors of executive agencies. The Council of State Governments, 1997 and 2004.

At the local level, privatization levels vary tremendously from one city to another. Greene (2002) placed cities into four categories (Survivalist, Market, Expansionist, and Maintenance) and examined the privatization level of each category. The most notable finding was that expansionist cities, those cities trying to move to a higher plane among relevant competing cities, were least likely to privatize (13.6 percent privatization level versus about 30 percent for the other categories). The low privatization level was primarily attributed to a strong local economy, growing tax receipts and low fiscal stress.

Greene further examines privatization levels by categorizing cities as central, suburban, or independent. The central city is the primary city in a standard metropolitan statistical area (SMSA), such as Nashville. The central city is the center of the area's commerce and other functions, such as health care and transportation, including the area's airport. The central city will often house a larger percentage of the area's poor and underprivileged, requiring a relatively high level of redistributive functions such as welfare and public housing. The high level of required government services tends to lead to a high level of organized municipal bureaucracies that typically oppose privatization initiatives.

Suburban cities are all other cities located in the SMSA, such as Franklin, Brentwood, and Forest Hills. Their proximity to the central city allows them to depend on that entity for many core functions, allowing them a relatively high

level of flexibility as to how they deliver many government services. Suburban cities can utilize intergovernmental arrangements with the central city, provide services through their own departments, or contract with private entities. Privatization levels are highest in suburban cities, which also tend to be wealthier and more politically conservative.

### **Outsourced Functions**

At the state and local level, the most commonly outsourced functions are considered “hard” services and include paving, landscaping, janitorial services, building maintenance, garbage collection and disposal, construction, transportation, and managing parks, convention centers, and airports. These services are not unique to government entities and therefore have corresponding private sector equivalents and a ready supply of qualified non-governmental firms willing and able to assume these functions for the government. According to most accounts, privatizing these services generally results in satisfactory or superior service and sometimes significant cost savings (Greene, 2002).

At the local level, privatized services typically share the following four main characteristics (Wang, 2004):

- low-profile activities that have no inherent reason to be conducted by the public sector
- private suppliers that are able to provide the service being offered by the local government
- relatively low job skills required to perform the services
- services with clearly defined outputs making it easier for government tracking and supervision

A 1995 survey of the 100 largest U.S. cities (66 respondents) identified the 10 most common privatized services (Dilger et al., 1997). Refer to Table 3. For example, 80 percent of all respondents outsource some or all of their vehicle towing services, but only 24 percent outsource drug/alcohol treatment centers. The list is notable in that for the vast majority of these functions, the client is the government itself. As we will discuss in more detail in the next section, state and local governments have increasingly turned to private entities to provide a

number of “soft” services for which individual citizens are the end client (e.g., welfare, child support), but privatizing those functions has lagged hard services.

**TABLE 3**  
**TEN MOST PRIVATIZED SERVICES**  
**IN AMERICA’S 66 LARGEST CITIES, 1995**

SERVICE	PERCENTAGE OF CITIES OUTSOURCING SOME SERVICES
Vehicle towing	80
Solid waste collection	50
Building security	48
Street repair	40
Ambulance services	36
Printing services	35
Street lighting/signals	26
Drug/alcohol treatment centers	24
Employment and training	24
Legal services	24

Source: Dilger et al., “Privatization of Municipal Services in America’s Largest Cities,” *Public Administration Review* (January/February 1997), page 22.

Table 4 below identifies the functions most commonly privatized by local governments and how the use of privatization has changed over time.

**TABLE 4**  
**PERCENTAGE OF LOCAL GOVERNMENTS**  
**REPORTING USING PRIVATE CONTRACTING**  
**IN SPECIFIED SERVICES, 1982-1997**

SELECTED LOCAL SERVICES	1982	1988	1992	1997
Vehicle towing and storage	80	80	85	83
Legal services	49	55	49	53
Residential refuse collection	35	36	38	49
Tree trimming and planting	31	36	32	37
Solid waste disposal	28	25	32	41
Street repair	27	36	30	35
Traffic signal maintenance	26	27	25	24
Ambulance service	25	24	37	37
Bus system operation	24	26	22	30
Labor relations	23	33	49	53
Data processing	23	17	9	15

Source: Service Delivery in the 90s: Alternative Approaches for Local Governments (Washington D.C.: International City/County Management Association, 1989) and Elaine Morley, “Local Government Use of Alternative Service Delivery Approaches,” *Municipal Yearbook 1999* (Washington D.C.: International City/County Management Association).



## **Benefits of Privatization**

Government agencies have chosen to use outsourcing for a variety of reasons. Competition between private entities encourages cost effective operations for the outsourced services and motivates remaining government agencies to improve their own operations to avoid having their operations moved to the private sector. Private organizations are more likely to use innovative technology and often have specialized personnel to perform complex tasks (Chi et al., 2004).

One of the main arguments in favor of outsourcing is that it can save local governments a significant amount of money relative to public provision (Savas, 1982, 1987; Donahue, 1989; Kemp, 1991). Government representatives have commonly cited other reasons for pursuing outsourcing, in addition to cost savings, that include obtaining access to specialized personnel or expertise, gaining flexibility and reducing red tape, implementing services quickly, attaining high quality services, allowing the government agency to focus on its core mission, providing immediate access to current technology, and improving efficiency (Chi et al., 2004; GAO, 1997; Goolsby, 2006; Scott 2003).

In the early years of privatization, some experts regarded the practice as a fad driven largely by political ideology and a desire for smaller government. That view is no longer accepted, and politicians of all ideologies are embracing privatization in a number of instances as a winner for all parties involved - but still subject to the circumstances of the individual agencies (Brudney et al., 2005). As we will expand on below, the decision to privatize is often driven by widespread dissatisfaction with current government services. As the table below indicates, fiscal pressures and a perceived inefficiency in current government services drive a large percentage of decisions to turn to the private sector. However, lack of state personnel or expertise and the inflexibility of government agencies are also frequently critical to the decision to privatize. In these instances, government leaders appear motivated by a desire to improve the quality of government services and not by simple cost savings.

**TABLE 5**  
**PRIMARY REASONS FOR PRIVATIZATION**

REASON	1997	2002
Cost Savings	44.8%	68.4%
Flexibility / Less Red Tape	29.3	32.8
High Quality Service	12.1	9.2
Increased Innovation	15.5	1.3
Increased Support of Political Leadership	32.8	1.3
Lack of State Personnel and Expertise	19.0	53.9
Speedy Implementation	19.0	14.4
Other	10.3	7.8

Source: Survey of state budget directors and legislative service agency directors. The Council of State Governments, 1997 and 2004. The amounts represent percentage of respondents citing each reason. Respondents could choose more than one category.

In a 2002 survey, the Council of State Governments (CSG) surveyed budget/legislative directors and heads of executive agencies to determine the primary reasons they chose to privatize some functions. The results are summarized in Table 6 below. It is interesting to note that budget and legislative directors view cost savings as the primary reason for privatization, while agency heads turn to privatization due to a lack of state personnel or expertise.

**TABLE 6**  
**PRIMARY REASONS FOR PRIVATIZATION**  
**COMPARISON OF BUDGET/LEGISLATIVE DIRECTORS**  
**VERSUS HEADS OF EXECUTIVE AGENCIES**

REASON FOR PRIVATIZATION	BUDGET/ LEGISLATIVE DIRECTORS	HEADS OF EXECUTIVE AGENCIES
<b>Cost Savings</b>	<b>68.4%</b>	<b>36.6%</b>
Lack of State Personnel or Expertise	53.9	50.7
Flexibility and Less Red Tape	32.8	27.1
Speedy Implementation	14.4	20.6
High Quality Service	9.2	12.5
Increased Innovation	1.3	9.5
Increased Support of Political Leadership	1.3	13.5
Other	7.8	14.0

Source: Chi, Arnold, and Perkins, 2004. Amounts represent percentage of respondents citing each reason.

The reason for privatization also varies by function. The table below (Table 7) breaks out the reasons for privatization by service category. The table shows that reducing costs is the primary reason for outsourcing public works and support functions, but factors other than costs when combined are the main reason to privatize health and human services, public safety, and parks and recreation.

**TABLE 7**  
**MOST IMPORTANT REASON FOR PRIVATIZATION OVERALL**  
**BY SERVICE CATEGORY, 1995**

SERVICE CATEGORY	REDUCE COSTS	IMPROVE SERVICE	REDUCE NO. OF EMPLOYEES	LIMIT LIABILITY	EMPLOYEE SKILLS INADEQUATE
Public works/ transportation	32	14	0	0	2
Health/ human services	13	10	0	0	4
Public safety	17	14	3	3	1
Parks, recreation /culture	16	12	0	4	3
Support functions	25	5	3	1	2
Overall	103	55	6	8	12

Source: Dilger et al., "Privatization of Municipal Services in America's Largest Cities," *Public Administration Review* (January/February 1997), page 24. Mail survey to 100 U.S. largest cities with 66 cities responding.

### **Outsourcing in Social Service Entities**

A study conducted by the U.S. General Accounting Office (2002) found that outsourcing occurs in almost every state and exceeded \$1.5 billion in federal temporary assistance for needy families (TANF) and state maintenance of effort funds in 2001 (Bandoh, 2003). The level of outsourcing across all functions at the state and local level is difficult to determine because the results cited in the literature depend on voluntary surveys, none of which had 100 percent response rates. However, we can get a general idea of trends from the literature.

Privatization has occurred in some jurisdictions in virtually every department. The table below (Table 8) provides some examples of social services that have been privatized at the state level. Note that respondents represent only a fraction of all state governments.

**TABLE 8**  
**PRIVATIZATION ACTIVITY IN SELECTED AGENCIES, 1997**  
**(Most Frequently Reported)**

<b>HEALTH SERVICES</b>	
Number of Responses: 29	
States Represented: 29	
<u>PROGRAMS/SERVICE</u>	<u>NUMBER OF STATES</u>
Family planning services	18
AIDS programs	15
Clinics	14
Infant mortality reduction	14
WIC programs	13
Drug and Alcohol treatment	11
Domestic violence services	9
Injury prevention services	9
Laboratory	8
Primary care	8
Research and development	8

  

<b>JUVENILE REHABILITATION</b>	
Number of Responses: 22	
States Represented: 22	
<u>PROGRAMS/SERVICE</u>	<u>NUMBER OF STATES</u>
Group homes	18
Mental health treatment	15
Clinical evaluations	13
Institutional residential programs	13
Substance abuse treatment	13
Sex offender programs	12
Supervised independent living	11
Day treatment services	10
Foster homes	10
Shelter care	9

## **MENTAL HEALTH AND RETARDATION**

Number of Responses: 31

States Represented: 28

<u>PROGRAMS/SERVICE</u>	<u>NUMBER OF STATES</u>
Community living support services	17
Psychiatric services	16
Developmentally disabled services	13
Therapists (activity, speech, recreational, physical)	13
Pharmacy services	12
Transportation and ambulance services	12
Mental health care services	12
Food services at institutions	10
Medical services at institutions	10
Laundry	9
Case management of mentally retarded	9
Parent support and advocacy	9

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## **SOCIAL SERVICES**

Number of Responses: 28

States Represented: 27

<u>PROGRAMS/SERVICE</u>	<u>NUMBER OF STATES</u>
Child care	15
Consultants/specialists	14
Independent living support services	14
Food stamp issuance	12
Domestic violence	12
Emergency shelters	12
Refugee services	12
Adoption programs	11
Day care programs	11
Drug and alcohol treatment	11
Foster care	11
Employment services	10
Programs for the elderly	10
Services for the disabled	10
Transportation of clients	9
Child welfare services	9
Client assessment/education	8
Psychological testing	8
Medical claim payments	7
Teen pregnancy prevention	7

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Source: Keon S. Chi. 1998. "Private Practices: A Review of Privatization in State Government," The Council of State Governments, Appendix.

Eggers and Ng (1993) surveyed several large counties across the U.S. to identify social services privatized in one or more of these large metropolitan areas. Privatized services included adoption services, child support collection, child welfare programs, day care, drug and alcohol treatment, employment training and retraining, programs for the elderly, vocational education and vocational rehabilitation.

A better idea of how privatization has changed over time is revealed by four surveys conducted by Greene between 1982 and 1997 (Table 9).

**TABLE 9**  
**PERCENTAGE USE OF PRIVATE CONTRACTING**  
**BY LOCAL GOVERNMENTS, 1982-1997**

HEALTH AND HUMAN SERVICES	1982	1988	1992	1997
Sanitary inspection	1%	3%	2%	4%
Insect/rodent control	19	15	15	21
Animal control	15	11	14	17
Operation of animal shelters	32	17	34	34
Operation of daycare facilities	72	34	88	79
Child welfare programs	31	17	17	27
Programs for the elderly	37	19	30	34
Operation/management of hospitals	30	24	61	71
Public health programs	37	19	13	30
Drug and alcohol treatment programs	51	24	54	56
Operation of mental health programs and facilities	50	35	44	45
Prison/jails	n/a	1	1	3
Parole programs	n/a	3	n/a	n/a
Operation of homeless shelters	n/a	43	59	66
Food programs for the homeless	n/a	26	n/a	n/a

Source: Survey of local governments (cities and counties) conducted by the International City/County Management Association. The number of local governments varied with each survey and the number of governments responding varied with each service. Some services were not included in all of the surveys and are designated as n/a in the table.

These surveys defined social services slightly differently than Eggers and Ng, but the trends are clear. Many respondents apparently embraced privatization in the late 1970s, and by 1982 outsourced services were common across the social services categories. Between 1982 and 1988, privatization levels dropped, sometimes dramatically, but rose steadily in the 1992 and 1997 surveys.

Traditionally, the approach to social services contracting has been non-competitive, quasi-grant agreements, particularly with non-profit organizations. There has been a shift however, with an emphasis on competition and performance contracting for the delivery of social services (Nightingale and Pindus, 1997). The discussion below identifies some common social services and discusses the record of outsourcing.

### Welfare Reform

Prior to the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, states were essentially prohibited from contracting out initial welfare intake and eligibility determination functions. With the passage of this law, these restrictions were removed. In the past, contracting for social service delivery was mainly for direct service delivery such as: job training, job search instruction, and the provision of day care services. The majority of service providers were non-profit, except for some of the contractors for data systems which consisted of large, for-profit companies. However, public agencies were still responsible for intake and eligibility determination. Now that entire welfare systems can be contracted out, large for-profit companies are becoming part of the welfare service delivery market (Nightingale and Pindus, 1997).

Examples include the for-profit company America Works, which has contracts in New York City, Albany, NY, and Indianapolis and provides support services for the first four months a welfare client is on a job. The client receives minimum wage, but the employer pays America Works a higher wage (similar to the type of arrangements typical of temporary employment agencies.) Additionally the government agency pays America Works for each successful placement. Maximus, Inc. is another for-profit company with significant government contracts, mostly in the welfare arena. Contracts include child support enforcement activities, a contract to recruit recipients into HMOs, welfare to work contracts in selected sites, as well as many contracts for data systems development in the human services area. Electronic Data Systems began with

computerization of Medicaid billing and welfare reporting systems. This company has a contract with Texas focusing on reengineering eligibility determination and service delivery for health and human services programs and working towards securing a new computer system for the state. Lockheed Martin has child support enforcement contracts as well as contracts to convert various welfare benefits to an electronic debit system (Nightingale and Pindus, 1997).

Several states have privatized portions of their welfare systems. W-2 Wisconsin Works is based on market competition for delivery of services. Under this effort, public, private, and non-profit agencies can compete for contracts to deliver the entire welfare system in specific localities. The Texas Integrated Enrollment system (TIES) is intended to integrate and streamline eligibility requirements including TANF, Food Stamps, and Medicaid using both public and private providers.

Several TANF services have been outsourced in various states. Although not common, some governments outsource virtually all case management functions including intake and diversion activities, eligibility and benefit determination, development of the individual responsibility plan, assessment of the need for services, case monitoring and tracking, and sanctions for non-compliance with TANF requirements.

More often, jurisdictions outsource TANF services that are routinely provided in the private sector. Many for-profit and nonprofit entities are qualified to offer job search and placement assistance for TANF recipients and specialized employment programs (work experience, education, training, supported work, and job retention and advancement services) as well as support services such as child care and transportation. In some locations, non-governmental entities offer mentoring, initiatives to prevent teen pregnancy and programs to promote family formation.

The extent and type of privatization varies from one jurisdiction to another. The table below provides some idea of the variation between TANF services, service providers, and the type of contract with private entities.



**TABLE 10**  
**VARIATION ACROSS SITES IN TANF ADMINISTRATION,**  
**CONTRACTOR TYPE, AND CONTRACT TYPE**

SITE	RESPONSIBLE ENTITY	CONTRACTOR TYPE	CONTRACT TYPE
Delaware	State	For-profits Local affiliate of national non-profit Local non-profits Community colleges	Pure pay-for-performance
Hennepin County	County and City of Minneapolis	Local affiliate of national non-profit Local non-profits State agency	Cost-reimbursement
Lower Rio Grande Valley	State, Local Workforce Development Boards	Joint venture between a for-profit and a regional non-profit	Hybrid of cost-reimbursement and pay-for-performance
Palm Beach County	State, Local Workforce Development Boards	For-profits	Two contracts: (1) pure pay-for-performance (2) fixed price
San Diego County	County	For-profits Local affiliate of national non-profit	Hybrid of fixed price and pay-for-performance
Wisconsin	State	For-profits Local and regional non-profit County agencies Tribal Agency	Hybrid of cost-reimbursement and pay-for-performance

Source: McConnell *et al.*, 2003.

### Child Welfare

As of 1998, child welfare agencies in 29 states have implemented some type of privatization initiative. Kansas, for example, adopted a managed care system for its child welfare program statewide. In the beginning, private-sector

organizations were paid a set fee for each child referred, intended to cover the cost of all foster care, family preservation, or adoption services provided. After the private contractors proved unable to provide adequate services at the set price, Kansas officials agreed to amend the contract to compensate the private companies on a per-child per month basis for many services. Although the Kansas managed care initiative was terminated, both Tennessee and Ohio have also used managed care as a privatization strategy (Winston et al, 2002).

### Workforce Development

While the national regulations do not specifically instruct the privatization of services, they do encourage competition in the selection of both the administration of centers and service delivery agents. Competition for these one-stop service contracts is enjoyed by public and non-profit organizations as well as private, for-profit companies. The Massachusetts One-Stop Career Center Initiative allows private firms and public agencies to compete for contracts to manage career centers, serving as the gateways to the state's new workforce development system (Nightingale and Pindus, 1997).

### Department of Labor Employment Services

The contracting of service provision has been common in the U.S. DOL employment and training programs since the 1960s. One-stop career centers required under the Workforce Investment Act are often operated by non-profit organizations and private for-profit companies. A large for-profit company manages and operates several of these one-stop career centers in Polk County, FL, while another large for-profit company provides similar services in Massachusetts (Winston, et al., 2002).

### Child Support Enforcement

Child support enforcement legislation that passed in 1986 encourages states to consider contracts with private companies. States will contract out for

various activities including collection, payment processing, distribution of payments, as well as fully privatized offices (Nightingale and Pindus, 1997). Privatization of the collection of past-due support has been occurring since the 1980's. Since then states and localities have expanded privatization to include payment processing, paternity and order establishment, parent location, and customer service.

A 1996 study conducted by the GAO found that among the states that had some privatization of child support, the tendency for outsourcing was in the collection of child support payments from hard to locate or difficult to find parents as well as those with past-due support (Nightingale and Pindus, 1997). Some governments have turned over their entire child support operations to private contractors who take full responsibility for providing all program services. One or more fully privatized local office exists in 15 states. Currently, a single provider of full-service privatization, Policy Studies, Inc., operates offices in 16 states (Winston et al., 2002).

#### *Mental Health and Substance Abuse Services*

According to several surveys, the most commonly outsourced functions include mental health and substance abuse treatment. Perhaps because private entities commonly provide these services, governments have had good success with privatizing these functions.

#### *Innovative Practices in the Delivery of Human Services:*

Florida: In 2002, Florida received federal approval of a waiver for a pilot program allowing staff of private, for-profit workforce providers to perform food stamp eligibility determination. Under this program, TANF services are totally privatized and services are provided by a contracted vendor. The Florida Department of Children and Families and the contracted vendor share the responsibility for determining eligibility for the Medicaid and Food Stamp programs. The pilot program aims to “test the concept of privatization, create innovative service delivery strategies in a one-stop environment, improve client

services through the realignment of job responsibilities, promote work and career advancement at initial and subsequent client interviews, and develop an experimental base for future expansion of eligibility privatization.” (Bandoh, 2003)

Tennessee: In 2002, a new partnership in Memphis was announced. This program seeks to foster cooperation among the local workforce investment board, elected officials, grassroots organizations, and faith-and-community based groups to improve employment outcomes for residents of Memphis. The mission of the new center is to engage more faith and community based groups in the delivery of public services by alleviating barriers to cooperation. The center focuses on the local level because the majority of grants from the Labor Department are passed to local workforce investment boards that provide services (Bandoh, 2003).

#### Summary of Social Service Outsourcing

The common theme across all outsourcing efforts is that functions that commonly exist in the private sector have been widely and successfully outsourced in many state and local governments. In the social service arena, mental health services, substance abuse treatment, and functions assisting beneficiaries in vocational training or obtaining private employment are very prevalent in the private sector and most commonly privatized by all levels of government.

Recent changes in federal law have allowed or encouraged large private companies to begin assuming functions more traditionally limited to government agencies, such as welfare, corrections, child support, and various TANF functions. The track record of these privatization efforts are mixed with some successes but also some notable failures. The fact that fewer competitors exist for these functions could explain the mixed results. The next section discusses in more detail the positive or negative impacts of privatization on various constituencies.

## **Value Added of Outsourcing in Government**

Government agencies have chosen to use outsourcing for a variety of reasons, but the theoretical justification is very simple. The promise of outsourcing is that free-market competition encourages the provision of high quality products and services delivered in a cost efficient and effective manner. In an ideal situation, a government entity replaces a monopoly (the government agency) with an entity that competes in the free market like any other business. The government often remains as one of the competitors and can compete for contracts alongside private for-profit or non-profit entities.

Private organizations succeed in part because they have access to and utilize the most current and innovative technology. Private organizations also frequently employ highly trained and specialized personnel to perform complex tasks. Using these specialized skills across a number of clients can make these highly trained individuals cost effective and profitable for private companies in a manner not possible for a public entity (Chi et al., 2004).

The success or failure of a privatization effort depends on the motivation to move a function to the private sector. Successful outsourcing is frequently equated with cost savings, and in fact government leaders often cite cost savings as the most important motivation for privatizing a function. However, government representatives commonly cite several reasons for pursuing outsourcing projects that include not only cost savings, but also obtaining access to specialized personnel or expertise, gaining flexibility and reducing red tape, implementing services quickly, attaining high quality services, allowing the government agency to focus on its core mission, providing immediate access to current technology, and improving efficiency (Chi et al, 2004; GAO,1997; Goolsby, 2006; Scott, 2003).

In this section, we review the literature for available evidence on the effectiveness of outsourcing efforts for a variety of government functions.<sup>4</sup> Much of the literature concentrates on cost savings, but we would caution against using

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<sup>4</sup> Greene (2002) provides a summary of major efficiency studies for a variety of municipal services for both domestic and international cities, including bus service, cleaning services, electric power, fire protection, hospitals, refuse collection, vehicle maintenance, and water utilities.

the presence or absence of cost savings as the sole yardstick for determining the effectiveness or desirability of outsourcing a particular government function. Cost savings are an important reason to consider outsourcing, but certainly not the only reason as indicated by Tables 5-8. Further, the cost savings are based on voluntary responses by government officials who may not have sufficient data to make an accurate determination. With those cautions, we will review the evidence available.

The literature has somewhat mixed results regarding the efficiency of contracting out. Brundy et al. (2005) surveyed agency heads and found that only one-third of the responding agencies reported cost savings and approximately half reported improved service quality.<sup>5</sup> Savas (2000) reports cost savings average 25 percent based on studies from different counties. However, Hodge (2000) reports cost savings of 6-12 percent, but finds that the effect of contracting on service quality remains largely unknown. While there are a number of studies that compare public and private service delivery, many researchers still question the methodological rigor and validity of the studies (Barnekov and Raffel, 1990; Fernandez and Fabricant 2000; Sclar 2000).

Table 11 below identifies eight activities that typically produce dramatic and consistently positive cost savings. It is notable that all of these activities have many private sector competitors, the responsibilities and obligations of the private entity are easily identified and detailed in RFP's, and government officials should have no difficulty monitoring the quality of the output.

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<sup>5</sup> The authors rely on the 1998 American State Administrators Project (ASAP) survey, which surveyed 95 different types of agency across all U.S. states. A total of 1,175 of agency heads responded to the survey (33 percent).

**TABLE 11**  
**COST ADVANTAGES FROM PRIVATIZATION**

SERVICE	PRIVATE CONTRACT SAVINGS (%)
Asphalt overlay	96
Janitorial service	73
Traffic signal maintenance	56
Street Cleaning	43
Garbage collection	42
Turf maintenance	40
Tree maintenance	37

Source: Barbara Stevens, "Comparing Public- and Private-Sector Privatization Efficiency: An Analysis of Eight Activities," *National Productivity Review* (autumn, 1984), p. 401.

The activities identified above are not typical of many government functions that may be candidates for outsourcing. The results of government outsourcing arrangements and their impact on the government agencies participating in them have varied considerably. Table 12 below illustrates the wide variation in cost savings.

**TABLE 12**  
**PERCENTAGE COST SAVINGS REPORTED BY STATES**  
**AND SELECTED AGENCIES, 2002**

	STATE BUDGET DIRECTORS	AGENCY DIRECTORS	PERSONNEL	HEALTH / HUMAN SERVICES	CORRECTIONS
No savings	18.4	32.6	---	---	2.0
Less than 1%	10.5	12.0	13.1	35.1	29.1
1- 5%	2.6	5.0	7.8	10.8	20.8
6 – 10%	1.3	3.0	5.3	2.7	10.4
11 – 15%	1.3	2.5	2.6	2.7	2.0
> 15%	3.9	29.1	5.2	0.0	4.1
Unknown	23.6	6.0	26.3	43.2	25.0
No response	38.1	9.8	15.7	5.4	6.2
No privatization	---	---	23.7	---	---

Source: Chi, Arnold and Perkins, 2004.

The cost savings data presented above came from questionnaires sent to state budget directors (column 1), with separate questionnaires sent to directors of five large agencies in each state (column 2). If both sets of respondents had access to accurate data, columns 1 and 2 should be nearly equivalent, although not all agency directors were surveyed. However, 29 percent of agency heads reported cost savings exceeding 15 percent, but only 4 percent of state directors reported statewide savings that large. In fact only 9 percent of state budget directors estimated statewide savings in excess of 1 percent. It is also notable that even among agency heads, 45 percent reported cost savings of 1 percent or less. For Health and Human Services directors, 78 percent either could not estimate cost savings or saved 1 percent or less, and only 5.4 percent estimated cost savings greater than 5 percent.

Some agencies reported significant positive results from privatization, although roughly equal numbers save very little from their outsourcing efforts. But since outsourcing levels have not declined in recent years, the mixed record on cost savings indicates that other factors influence privatization decisions and that agencies have not been reversing outsourcing decisions even when hoped-for cost savings do not materialize. See Table 12.

The Chi et al. (2004) survey examined the primary reasons for the use of privatization among certain state agencies, including personnel agencies, education agencies, corrections agencies, and transportation agencies. Among these groups, personnel agencies cited a lack of state personnel and expertise, cost savings, and high quality private services as the primary reasons for privatization within their departments. State education agencies most often noted a lack of personnel and expertise as reasons for privatization and in fact almost half (48.5 percent) of the education departments surveyed reported cost savings from outsourcing of less than 1 percent. Directors of corrections agencies reported cost savings, flexibility, and lack of state personnel or expertise as reasons for privatization. Transportation agencies cited a lack of staff with specialized skills and expertise as a primary reason for privatization. Clearly cost



savings were not always the primary motivation for privatization, and therefore the ambiguous results on realized cost savings should not trouble governments contemplating outsourcing as a method to improve services.

GAO Survey – Successful Privatization Efforts Examined

In a 1997 study completed by the GAO, the agency examined the privatization approaches of six governments that had undertaken extensive and successful privatization efforts. The six governments studied were Georgia, Massachusetts, Michigan, New York, Virginia, and Indianapolis, Indiana. Officials in these six governments as well as a panel of experts surveyed pointed out that reliable and complete cost data for government activities are needed to make sure that the competitive process is thorough and to assess performance of the private vendor. The six governments surveyed developed information on the cost of the government activities that were candidates for privatization. Four governments used “best estimates” of costs, citing the difficulty of obtaining complete cost and performance data from their accounting systems. For example, Massachusetts used estimates of costs when evaluating privatization candidates due to the difficulty of obtaining complete cost data from the state’s accounting system. However, the Massachusetts State Auditor later questioned the reported savings from some of these activities, noting insufficient cost analysis before privatization and a lack of corroborating data on the benefits claimed after privatization. Two governments, Virginia and Indianapolis, went to great efforts to go beyond such “best estimates” and used sophisticated management accounting techniques to identify all costs associated with performing a government function. These two governments stated that getting more complete data took more time and considerable expense, but it helped the government identify cost savings and better evaluate the proposals from private vendors.

The six governments surveyed in the GAO report pointed out that monitoring and oversight are a critical but often overlooked element of any successful outsourcing program. Auditors must evaluate both compliance with

the terms of the agreement (e.g., payment in accordance with contract terms) and performance quality. Most of the state and city officials interviewed for the report stated that performance monitoring is more difficult than contract auditing.

Officials in every government except Indianapolis cited performance monitoring as the weakest link in their processes. All of the governments interviewed said that they are attempting to improve the skills of their employees to allow them to undertake more advanced monitoring. In addition, all six governments interviewed noted that independent oversight of the privatization effort is vital to present a more objective, unbiased evaluation than would be possible by “inside” parties. These six governments all stated that they have independent entities that provide various levels of oversight.

Each of the six governments studied provided anecdotal examples of the reasons for and results of various outsourcing projects they have undertaken. While these examples are difficult to generalize, they serve as useful guidelines for what types of functions have been successfully privatized and what improvements in both cost and quality can be expected in the right circumstances. The literature is in fact consistent that successful privatization is a case by case process that requires in depth up-front analysis and consistent follow through.

Georgia: Georgia chose to outsource the operation of the Milledgeville War Veterans Home after an analysis indicated that its costs were significantly higher than those in six benchmark states. The project reported a cost savings of 57 percent over five years. In addition, the State reported that staff members were more responsive and that the quality of life for residents has been enhanced. Georgia outsourced its automobile maintenance because it was not a core function of the state. This outsourcing generated cost savings of approximately \$300,000 per year, which represents a 40 percent savings over the cost of government provided services. Finally, Georgia decided to outsource the Lake Lanier Islands recreational area because it was not a core function of the state.

This outsourcing was expected to generate \$300 million to \$350 million over the 50 year life of the contract.

Massachusetts: Massachusetts outsourced highway maintenance in Essex County to improve the quality of the highway maintenance. The state reported total savings of more than \$4.5 million from the first year of the contract. In addition, highway maintenance services improved.

Michigan: Michigan opted to outsource the physical security at military facilities to achieve cost savings. The state reported that it achieved savings of approximately \$1.2 million in fiscal year 1996, which represented a 70 percent savings for the year. In addition, it allowed the state to meet federal requirements within the limitations of federal funding. Finally, one facility has increased the level of security with improved monitoring.

New York: New York outsourced its tax form processing to achieve cost savings and improve the efficiency of processing tax returns. The state reported estimated annual savings of \$7.5 million from the outsourcing project.

Virginia: Virginia chose to outsource its delinquent tax collection to increase collections and reportedly improved the collection of previously uncollectible accounts. The state estimated \$6.8 million in additional collections during the first year of the project.

Indianapolis: Indianapolis has arguably the most successful privatization program among cities. The city outsourced its wastewater treatment functions to achieve cost savings estimated at \$65 million, or 42 percent, between 1994 and 1998. In addition, the project improved quality and increased capacity with fewer staff. The city outsourced its airport management as a way to promote economic development. The project reportedly generated \$105 million in cost savings or new revenues between 1995 and 2004, representing a 28 percent savings over government provided services. In addition, the project increased retail selection and quality for passengers. Indianapolis also outsourced the maintenance of streets and attained cost savings estimated at \$700,000, or 30 percent, between 1992 and 1996. Further, the outsourcing led to an increase in crew productivity

and in the number of lane miles repaired. In yet another outsourcing venture, the city outsourced its audio-visual and microfilm services which produced approximately \$1.5 million in cost savings between 1992 and 1995, representing a 54 percent savings over government provided services. In addition, the project eliminated a substantial backlog of service requests and improved service to citizens. Finally, the city chose to outsource vehicle maintenance which saved an estimated \$4.2 million, or 21 percent, between 1995 and 1997. In addition, the project led to fewer labor grievances and a decrease in the cost of workers compensation claims.

### IT Examples

In a separate report, the GAO (2002) reviewed IT desktop outsourcing in six government agencies during 2002. The six agencies cited improving IT management, obtaining or upgrading technology, and improving user support and productivity as the primary reasons for outsourcing. Each of the six agencies reported that the desktop outsourcing had attained positive results, including improving end-user support, enhancing mission support, upgrading technology, and improving IT management. However, the GAO could not determine whether the agencies were actually realizing anticipated costs and quality benefits. For example, a private-sector firm assessed NASA's desktop outsourcing project in November 2001 and concluded that it was impossible to determine whether NASA had saved money because the agency lacked a complete baseline from which to measure results. On the other hand, the private assessment found that 90 percent of NASA management officials stated that the outsourcing provided some benefits such as standardization and improved service. In addition, the Treasury, the Peace Corps, and the Defense Logistics Agency were all in the process of obtaining project reviews.

The city of Evansville and Vanderburgh County, Indiana, have outsourced their information management services as a way to reduce costs by 23 percent. In addition, the new hardware put into place has helped improve response time and

decrease downtime (*American City & County*, 1997). In addition, Douglas County, Colorado, outsourced its bill processing and cost management of its telecommunications expenses and reported cost savings of almost \$267,000 since 1998 (*Government Procurement*, 2002).

### Other Examples

Scott (2003) reported that Florida signed an outsourcing contract with Convergys in August 2002 to outsource its human resources functions in what is thought to be the largest outsourcing project of its kind to date. The project was expected to save the state \$173 million over the seven year life of the contract. The Florida Department of Management Services described the benefits of the outsourcing project as allowing agencies to focus on their core missions, providing better service, reducing expenses, redirecting funds to other priorities, providing immediate access to up-to-date technology, and moving Florida into the forefront of e-government. An independent third party contract monitor was to oversee the quality assurance surveillance plan and performance measures.

Frisch (2005) reported that Alaska created a pilot project to outsource procurement services, supply chain management, and electronic purchasing tools from its Department of Transportation/Public Facilities to Alaska Supply Chain Integrators (ASCI). The project seemed to be meeting the major operational elements of the program, but the Department of Administration has had difficulty auditing performance to measure improvements.

Eger et al. (2002) examined public sector outsourcing of transportation services and noted that several jurisdictions have been successful in creating competitive outsource operations. They pointed out that “many members of state legislatures, county commissions, and city councils have embraced the premise that the private sector can deliver most public services better, faster, and cheaper than public employees.” The transportation division respondents surveyed reported using experts to evaluate outsourcing options 22.2 percent of the time. In addition, approximately 57 percent indicated that access to information has

improved over time as a result of the outsourcing. Regarding performance evaluation, the majority of the transportation division respondents reported that performance is measured on either a weekly or monthly basis.

On the other hand, Garrett (2002) pointed out that “government surveys have revealed widespread service contracting problems, including deficient statements of work, poor contract administration, performance delays, and quality shortcomings.” Increased use of outsourcing by the federal government has increased the importance of performance-based contracting for these agreements. As an example of one state agency that has begun to use performance-based contracts, the DOE Idaho Operations Office contracted with Lockheed Idaho Technologies Corporation (LITCO) in 1994 to manage and operate the Idaho National Engineering Laboratory. The contract was highly complex and combined a fixed-price component, a cost-plus-incentive-fee, and a cost-plus-award-fee.

A report by Goolsby (2006) indicated that governments are more frequently using incentives and disincentives for performance-based contracts in outsourcing projects. The report also pointed out that several notable large outsourcing arrangements in recent years did not work as anticipated (e.g. Navy-Marine Intranet). Gibson (2006) updated the status of the Navy-Marine Intranet project by reporting that the Navy renewed the contract with EDS after agreeing to pay \$100 million of \$780 million of claims for work performed. The new contract contained provisions to hold both the government and contractors accountable and contained performance incentives and disincentives.

### *Summary of Value Added on Outsourcing in Government*

The case studies discussed above indicate that outsourcing is not a universal cure all for ineffective or inefficient government. For example, the 2004 International City/County Management Association (ICMA) survey of 5,370 municipalities and counties (1,283 responded) found that 22 percent of all respondents brought back in-house services that were previously outsourced.

Seventy five percent reported poor quality and 51 percent reported insufficient cost savings as the reasons for bringing services back in-house. We can identify features that are common to most successful outsourcing programs related to “hard” services (social services will be discussed in the next section).

- (1) The service is easily described and quantified.
- (2) Many private sector competitors exist that are capable of performing the government function.
- (3) The government successfully identifies the quality expected and monitors the private vendor to ensure quality and efficiency standards are being met.

The common thread for most successful outsourcing programs can be simplified even further to the introduction of competition with effective up-front contract specifications and follow-up monitoring.

### **Value Added of Outsourcing on Social Service Agencies**

Outsourcing of social services has lagged hard services for several reasons. Table 12 indicates that for Health and Human Services, cost savings were reported as generally small, with only 5.4 percent of agency directors reporting cost savings greater than 5 percent. For many functions included in the social services category, private providers do not exist or are rare, making it difficult for governments to find qualified bidders for some functions, and surveys suggest that cities do not have a good program for measuring performance (Martin, 1992). Further complicating the evaluation of the performance of private contractors is the difficulty in developing performance guidelines. For example, how does the government measure the success of a job training program without a suitable benchmark? The output, hours of training, for example, is easily monitored. But it is less clear how to evaluate whether the training is cost effective and what the clients need at that time.

However, the literature does provide some examples of successful outsourcing efforts for many social services as well as some notable failures. Most

studies find modest cost savings and quality improvements. For example, in a review of the literature on privatization of welfare, Winston et al. (2002) support the basic theoretical reasons for privatization such as cost savings and improved quality of services with specific studies and surveys that provide information regarding the realities of outsourcing among social service agencies. Although the results do not differ greatly from the theoretical expectations of privatization of public services, the evidence suggests that outsourcing social services is likely to produce only modest cost savings or quality improvements. In terms of cost savings, Winston et al. (2002) focus on three sources – a 1993 survey conducted by the Reason Foundation, a 1996 study on the cost effectiveness of privatized services by the GAO, and a 1998 survey among several social service agencies by the Council on State Governments. The results were mixed. The Reason Foundation's study showed signs of cost savings, but they were fairly low – the majority of respondents reported less than 10 percent savings and 45 percent of respondents reported no savings whatsoever. Eggers and Ng (1993) cited insufficient competition in bidding as a potential reason for the modest cost savings in the Reason Foundation study.

The GAO study provided a clear definition of cost effectiveness – the administrative costs of collecting one dollar – but found that the results differed greatly among the state agencies that were surveyed. Arizona's outsourced program was found to be 18 percent more cost effective than the public operations, and a Virginia social service agency's privatized operations were found to be 60 percent more cost effective. On the other hand, one of Tennessee's social service agency's privatized operations was found to be more than 50 percent less cost effective than the public operations.

Without a doubt, it is important to zoom in on the level of quality provided by privatization and whether or not the service quality was improved as a result of privatization. This research is especially limited, but Winston et al. (2002) indicate that some empirical evidence suggests that privatized services are generally the same or slightly better in terms of quality compared to the public



sector. However, they point out that it is important to understand that results may be biased because those services that are typically privatized are often public services that are particularly ineffective in the first place. The 1996 GAO study focusing on child support enforcement found that performance levels of privatized services were at least as good as and sometimes better than publicly provided services. There were specific measures used to capture these results including outcome measures such as the success in locating non-custodial parents, establishing paternity and support orders, and obtaining collections. In a different study, the GAO (1997) evaluated two county-level contracts with regards to employment training in the state of California. The results were mixed – one contract illustrated higher performance from the private company than the county workers while the other contract showed lower performance by the privatized company.

Chi et al. (2004), in a survey focused on trends found in privatization, directly examined privatization within social service agencies. Although the details are condensed, they find that cost savings are either largely unknown or relatively low (in most cases less than 1 percent). These results are parallel to the survey's findings that suggest that most privatization occurs among social service agencies due to the lack of personnel or expertise within the agency or more flexibility and less "red tape." Therefore, the chief objective of most agencies in the survey was not to save in terms of costs but to increase the quality of the service via greater expertise.

### Welfare/TANF services

Nightingale and Pindus (1997) examine the privatization of welfare or TANF services after the Personal Responsibility and Work Reconciliation Act (PRWORA) of 1996. The act significantly changed the federal welfare program and made it possible for welfare agencies to contract out the entire welfare system including intake and eligibility determination. Two large for-profit corporations dominate the market for providing TANF and related services – Maximus and Affiliated

Computer Services, Inc. (ACS) (Winston et al., 2002). Other for-profit firms providing TANF services include Curtis and Associates, Policy Studies, Inc., American Works, and Association for Research and Behavior (ARBOR). Several smaller for-profit and nonprofit organizations also participate in providing TANF and other social services.

Evaluating the performance of the private sector competitors in the TANF arena is a challenge. Organizations such as Mathematica Policy Research, Inc. and the GAO have evaluated the prevalence of privatization for TANF functions, but to this point only case studies exist to evaluate performance. The task is more difficult because the contracts vary tremendously from one jurisdiction to another. In some cities, a single company offers a one-stop solution while in other cities, the functions, such as case management, employment services, child care, transportation, etc. might be delivered by a combination of private entities and government agencies. Types of contracts vary as well and include fixed price contracts, cost reimbursement contracts, and performance based contracts, as well as combinations that include fixed price or cost reimbursement and incentive bonuses. Finally, defining a quality outcome is difficult for many social service functions.

Owitz (2001) examines the performance of several large for-profit companies that have been actively pursuing TANF contracts across the country. The article details problems encountered by various jurisdictions with four large providers: Maximus, Inc., Lockheed Martin, America Works, and Curtis and Associates. The analysis is limited to a few locations, but the author noted serious shortcomings in those locations. For example, it was found that in one county almost one out of every seven clients filed a complaint against the for-profit provider of TANF services (3,000 complaints). In another location, recipients were apparently not made aware of all the benefits available to them, such as educational and child-care subsidies, because of poorly trained case managers or incomplete information. Owitz (2001) also alleged that in other locations the for-profit firms reduced their workload by unfairly kicking workers out of training

programs or not providing promised services for the time length agreed to in contracts.

Owitz (2001) finds that privatization is not efficiently delivering job training and support services to those individuals who actually need them. Also, many bonuses and other financial incentives that private firms receive for reducing caseloads create an incentive to terminate client benefits rather than help assist clients out of poverty. Many of the staff members working for private companies have neither the credentials nor the training needed to handle their caseloads, resulting in clients not receiving their entitled services. Owitz (2001) adds that the reason for much of the controversy in the realm of outsourcing is due to the simple fact that for-profit corporations ultimately are interested in maximizing profits for their shareholders rather than benefiting the members of their communities by providing the best services possible.

Arizona began a pilot TANF program in 1999 called Arizona Works that was administered by Maximus, Inc. alongside a publicly-administered program called EMPOWER Redesign. The purpose was to evaluate the cost and quality of the outsourced functions to the government provided services. An evaluation was completed in 2002 by Robert Kornfeld of Abt Associates, Inc. The general findings were the privatized Arizona Works and EMPOWER Redesign had similar outcomes. Costs were difficult to directly compare between the programs because the public agency and Maximus had different responsibilities, but the final cost-benefit finding was that Arizona Works was most likely more costly than the equivalent publicly-provided services (Kornfeld and Peck, 2003).

The evaluations to date of privatized TANF functions are mixed. The limited evidence suggests that cost savings will be small unless obvious problems exist with the public agency currently providing the services. The private sector also does not appear to offer clearly superior outcomes, although measuring success or failure is difficult. In many locations, a limited number of qualified bidders will limit competition and the benefits that competition offers to the outsourcing process. Winston et al. (2002) suggest increasing competition and perhaps

quality outcomes by dividing TANF functions into many pieces to increase the number of entities that are qualified to bid on the various pieces of TANF services rather than relying on one large vendor for all services.

#### Summary – Value Added for Outsourcing Social Service Functions

The process of outsourcing a social service from the public sector into the private sector must be judged on a case-by-case basis. However, general conclusions for the value added from outsourcing social service functions is similar to the value added from outsourcing “hard” services discussed in the previous section. When many qualified vendors exist in the community that will bid on providing the function, privatization generally results in a high quality product and modest cost savings. The tables presented earlier confirm that the services most often privatized are those that are provided on a routine basis in the private sector, such as mental health, substance abuse, employment training and job placement. Governments must be more careful when contracting out social services, however, because defining positive outcomes and effectively monitoring the private contractor creates a significant burden on government employees, especially those without significant experience or training specific to writing contracts for social services.

#### **Best Practices**

The literature and the experience of state and local governments provide many best practice guidelines when a government decides to consider privatizing a public function. The GAO (1998), for example, identified six governments (five states and one local government) with widely respected privatization programs and identified six components common to successful privatization efforts:<sup>6</sup> (1) A political leader or small group of leaders to champion the effort, (2) a formal structure to guide implementation, (3) legislative changes and/or reductions in allocated resources to encourage change, (4) reliable cost

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<sup>6</sup> We discuss these criteria in relation to outsourcing, which represents approximately 80 percent of all privatization efforts.

data, (5) strategies to deal with work force transition, and (6) post-privatization monitoring and oversight. A (2004) report by the Council of State Governments surveys a much broader sample of state and local governments and identified many of the same key points, but also added that governments should develop clear and measurable goals, use team efforts, and invite participation of employees in the privatization planning phase (Chi and Jasper, 1998).<sup>7</sup> We will organize this section using the six critical components identified by the GAO, supplemented with additional relevant research. The section concludes with a discussion of the importance of competition in successful outsourcing efforts, including the growing use of public-private competition in comprehensive privatization programs.

### *Political Champion*

Most often the political champion is the government's chief executive (e.g. Governor or Mayor), and building a consensus for change and privatization is his or her responsibility. Now that privatization efforts have a long history, looking to the successes and failures of other similar governments with privatization is one way to begin building a consensus for change. Political leaders can learn from others' experiences and begin assembling the data to convince the stakeholders, including government employees, that privatization can be a winner for all involved. Surprisingly, the CSG (1998) found that only 19 percent of privatization efforts looked to other government entities for advice on their privatization experience. Approximately 70 percent did not use a standard model or formal process for deciding which functions should be privatized.

One widely respected privatization program detailed in the literature is the Commonwealth of Virginia's efforts. The Governor and key legislators worked together to identify activities suitable for privatization, evaluated those activities in a systematic way, and cooperated to recommend privatization initiatives. Virginia certainly was not unusual with its approach. Many government entities

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<sup>7</sup> For an additional reference on best practices, see Garret (2002).

with successful privatization programs used an advisory group or commission to evaluate privatization possibilities and to assist in building government wide support for the change. In fact, the commission can provide a political shield for agency heads who otherwise might be blamed for perhaps moving jobs in his or her own department to the private sector (Auger, 1999).

Hatry (1989) and others point out that privatization generally succeeds best when an underlying issue is forcing a change. For many governments, budgetary pressures combined with a political aversion to higher taxes are the impetus for privatization.<sup>8</sup> In other cases, the government service is being provided ineffectively or inefficiently, even though the government's finances are relatively sound. In either case, fiscal stress or poor service quality, political consensus is easiest to achieve, especially when multiple private companies exist ready to take on the task on an outsourced basis. For example, in Phoenix, AZ, the janitorial department was inefficient, costly, and populated with unproductive workers that could not be employed elsewhere in government (Greene, 2002). This department was the first of many privatized by Phoenix because the benefits were so clearly predictable. In fact, Phoenix saved at least \$250,000 the first year.

Even if a government decides that privatization is a viable option, a thorough examination of the reason for privatization is the essential first step for the political leadership. The initial thought is that privatization saves money, and as noted, this was given as a reason by many government leaders. However, it is perhaps one of the less convincing arguments for privatization, as we will discuss more fully below. Cost savings are often small or inaccurately estimated. In fact, the more compelling argument for outsourcing may be to quickly obtain the most up-to-date expertise, such as in IT functions, where essential economies of scale and knowledge of fast changing technology are more likely to be found in the private sector.

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<sup>8</sup> For more discussion on the effect of fiscal pressure on privatization of local services, see Kodrzycki (1998).

### Implementation Structure

Many governments form a commission to promote privatization efforts. Of the six governments reviewed in the GAO report, five used a government commission and four included a broad spectrum of representatives on the commission, including private sector representatives. In addition, five established a dedicated support staff to assist the commissions with data gathering, technical assistance, and necessary support work. Kost (1996) studied his state's efforts and the other commissions and concludes the effectiveness of these commissions depended in part on having a strong mission and a balance between the public and private sectors on the panel. Also important to a successful effort is working within a consistent and well-defined framework so that decisions can be made as objectively as possible. The task of developing the analytical framework used to evaluate various functions is left to the commission or the support units assigned to the commission. The State of Michigan developed an interesting model for evaluating each service targeted for possible privatization. This very thorough analysis (called PERM) yields four possible outcomes: privatize, eliminate, retain in current form, or modify but keep as a government-provided service (Auger, 1999; State of Michigan, 1992).

The type of privatization might depend on the state of the private market in the service area and what type of service is a target. Most governments begin privatization efforts with ancillary and support functions such as bookkeeping, payroll, food service, vehicle maintenance, grounds maintenance, etc. These are relatively straight-forward functions with many private sector suppliers (Auger, 1999).

Beginning a privatization effort with functions for which the government is the customer has several benefits (Auger, 1999). The government as end user can easily evaluate the service. Starting "small" with a relatively low-risk function also acts as a barometer for the skill and preparedness of the privatization committee and support staff for more ambitious projects, as well as signals the likely support or opposition of the core constituencies. Finally, privatizing these

low risk functions allows the government to develop and test evaluation procedures, develop model contracts, develop skill in writing and specifying the terms of the contract, and develop monitoring procedures – all while the public risk of failure is relatively slight.

Even when a government decides on a method of privatization, such as contracting out certain services, the details of the contract, how responsibilities are defined, penalties or bonuses for meeting targets, etc. can determine success or failure. Agencies must be specific about performance requirements, quality levels, services to be provided, and who (government or private contractor) will pay for each service.

For example, New Mexico decided to contract out its food service operations in the State's prisons (Hatry, 1989), but it failed to adequately spell out the contractor's quality and service requirements in the original request for proposal (RFP). New Mexico ended up rewriting its RFP three times – eventually spelling out details such as minimum protein served daily - before they were satisfied with the privately provided services. Kentucky failed to spell out who would pay for the legally mandated law library when it privatized its prison operations.

### Legislative and Resource Changes

The CSG (2004) report points out that privatization is no longer dictated by ideology but rather by the practical lessons learned by recent efforts. Privatization, when used in the right situations and in cooperation with government agencies and affected employees, can be a good solution for all parties. Chi and Jasper (1998) recommend involving employees in the planning phase and using team efforts so that the government can achieve consensus across the spectrum. Some of these necessary steps fall into the category of political champions and were discussed earlier; however, others might need explicit legislative approval to accomplish their goals. Legislatures often establish independent panels with defined authority to examine potential targets



of privatization efforts. Virginia took this course of action by enacting the Virginia Government Competition Act of 1995. (GAO 1997)

In the legislative arena, lawmakers should further ensure that existing civil service laws allow for certain services to be privatized and employees transferred to the private sector. Georgia, for example, changed its civil service laws to make hiring and firing government employees easier (GAO, 1997). Perhaps existing laws or regulations require the state or local government to provide certain services, and therefore without changes in the law, privatization cannot occur. Another important concern is grants from other governmental units or private entities that perhaps cannot be received by private companies who might violate grant terms in other areas or related businesses. For example, private employers might not conform to diversity or equal employment goals set by the grantors. Legislatures will need to evaluate their own diversity and equal employment requirements and determine whether these standards should or do apply to the private contractor.

Other potential legislative actions include reducing resources allocated to a department as a signal to indicate that efficiency gains are a serious goal and to encourage departments to look to privatization if savings could be obtained by changing the method of service delivery. Indianapolis took the further step of permanently eliminating several middle management government positions to send a signal to the departments that privatization efforts were serious. It had the added benefit of generating some goodwill with the unions, since the potential government job losses would not be limited to lower level laborers.

#### Reliable Cost Data

The literature clearly finds that cost savings are often an insufficient reason for privatization. According to surveys by the CSG, the cost savings are often small or non-existent. For example, in their 2002 survey of state budget directors, respondents most often did not know the costs savings (23.6 percent), reported no savings (18.4 percent), or reported savings of less than 1 percent (10.5 percent).

Only 6.5 percent reported cost savings greater than 5 percent. Even the cost savings reported by surveys are likely overstated or at least not accurately determined. For example, department heads report a higher level of savings than their superiors (e.g. comptrollers or budget directors).

A significant issue highlighted by the GAO and CSG reports is that many governments do a poor job determining costs and cost savings before and after a privatization effort. Government accounting systems are often simple and do not provide the kind of cost and expense data necessary to perform an accurate analysis. For example, a department head might have his/her overhead allocation for the county building reduced because his/her staff was reduced by 75 percent following a privatization. For his/her department, the savings for overhead allocation, depreciation, utilities, maintenance, etc. are significant, but for the government itself, the space is either vacant or filled with other employees, resulting in little savings as a whole to the government.

Virginia, Indianapolis, and other government entities have turned to activity based costing and other sophisticated management accounting tools to obtain accurate estimates of the variable and fixed cost impact of privatization efforts (GAO, 1997). Without these sophisticated and costly efforts, the savings reported by surveys are likely to be inaccurate because of the problem of estimating cost behavior before and after privatization efforts, and they should be viewed with some suspicion. In addition to the CSG survey reported above, the GAO reports that Massachusetts leaders questioned the reported savings from its privatization efforts because of inadequate cost analyses before and after the effort. In some jurisdictions where political opposition to privatization is strong (e.g. from unionized government employees), the lack of concrete cost data could provide a potent political tool to thwart outsourcing efforts.

On a more practical level for privatization efforts, obtaining reliable and complete cost data for an activity slated for privatization informs decision makers about the issues that will need to be addressed when the RFPs are issued (GAO, 1997). Completely describing the costs involved in providing a service is a good

start towards fully identifying the requirements to be assumed by bidding firms if the activity is privatized. Complete cost data also better enables government to identify potential cost savings as well as evaluate bids received from the private sector.

Accurate cost data, however, is often difficult to obtain, especially for some functions. For example, Virginia could only obtain reliable cost data on 45 percent of activities up for privatization (GAO, 1997). Since most government accounting systems are not configured for sophisticated cost analysis, the process is time consuming and may require outside expertise, often at considerable expense both internally and in consulting costs. However, obtaining complete data might help mitigate one source of political and private opposition – questioning claimed potential savings.

#### Manage Workforce Transition

Managing workforce transition is important for several reasons. Potentially displaced employees can be an important source of opposition to privatization efforts. Depending on the size and strength of organized labor, their opposition could prove troublesome. CSG and the GAO report recommend involving employees early in the privatization effort. Massachusetts leaders for example, initially ignored powerful labor unions in their early privatization efforts, and those unions successfully blocked their initial efforts.

Indianapolis, on the other hand, had a comprehensive plan to involve its government workers. Management employees were involved early on, and the Mayor added union employees to the process after some labor groups had early concerns. The privatization plans eventually enabled employees to bid against private firms for work, provided training and performance bonuses and provided a safety net for workers not able to find jobs with the private contractor or elsewhere in government.

Privatization also requires new skills for remaining employees who will be given the task to oversee and monitor the private contractor. Formal training

programs of remaining employees to provide these skills can aid the transition, but many of the specialized tasks can also be found in the private sector until government employees get up to speed. New skills that may require specialized training include ability to analyze work flows and processes, detailed understanding of cost estimation techniques, ability to write detailed and accurate contract requirements and requests for proposals, and understanding the methods and tools available to monitor the performance of contractors and customer service satisfaction (GAO, 1997).

Providing a safety net for workers that cannot be retained or employed elsewhere in the government is an essential step to avoid worker opposition to privatization efforts. Common programs include severance pay, early retirement, buyouts, subsidized training, and job search assistance. Governments must estimate the cost of these efforts in the cost benefit analysis (Hatry, 1989). Some localities formalized the right of displaced employees to be hired by the private firm taking over the responsibilities. However, hiring requirements limit potential savings to the government and decrease private firm flexibility. Many localities formalize and accommodate the right of displaced workers to bid on government contracts.

### Monitoring

Effective monitoring and oversight is critical to an effective privatization program. Contract auditing involves simply determining whether the contractor is performing under the contractual obligations and getting paid properly for work actually performed. Agencies must also ensure that changes can be made (e.g. replace the contractor, revise the RFP, take the service back in house) if the private entity fails to perform up to appropriate standards (Hatry, 1989). The monitoring function would normally be performed by an independent government entity to act as a check on both the private contractor and the entity responsible for performing government obligations such as payment and bidding.

The more difficult and perhaps more important oversight function involves technical or performance auditing to monitor the output of the private contractor for quality and performance under the terms of the contract. Examples include formally assessing customer service with surveys, monitoring requirements for air or water quality standards for a waste management firm, setting up complaint lines, and assessing the quality of medical care offered indigent taxpayers.

The most important step in a successful monitoring program occurs before the contract is prepared and bid. The GAO reports that Georgia and Virginia use ease of monitoring as a key variable to determine whether or not a function is suitable for privatization. Effective evaluation of a contract is impossible if the performance standards are vague, incomplete, not adequately defined in the contract, or do not provide a means to efficiently gather the necessary data. Although critical for the success of a privatization program, many government entities report that effective monitoring is the weakest link in their privatization programs.

### Competition

Throughout the literature, and in various ways, experts conclude the promise of privatization rests on competition. In other words, efficiency gains result from free-market competition rather than whether a service is provided by the public or private sector. According to many theorists, governments are inefficient largely because for many of their functions they are a monopoly with no inherent incentive to operate efficiently. When a service required by government, such as road building, fleet maintenance, janitorial services, etc., is put out for bid in the open market, many firms, and in many cases the incumbent government agency, compete for the business and therefore all have strong incentives to provide the best product at the lowest price. In simple cases such as these, privatization seems to work well. When many private competitors exist, the documented failures usually result from collusion or corruption which prevents free-market competition from occurring. The corruption prevents the free market

from operating and effectively results in a private monopoly with the predictable resulting high prices and inefficient operations.

An essential question for government leaders contemplating outsourcing a government function is whether or not private competitors exist that are able to take on the task. For example, Louisville, Kentucky found that no local entities were qualified to assume special needs adoption services being provided by a government agency. Privatization in that circumstance might only replace a government monopoly with a private monopoly with little hope for substantial cost savings or improved service delivery. If competitors do not currently exist, can the government create a market? In the discussion of outsourcing social services, we discussed one method to increase competition is to break a function down into several component parts because many entities might be able to perform some, but not all, of the tasks involved in a large function such as TANF. A common theme in the literature is that outsourcing is least effective when few qualified private competitors exist. The ambiguous cost savings for many social service functions that are traditionally reserved for government entities is consistent with the predictions of the literature and survey results.

#### Public-Private Competition

For the initial rounds of privatization, outsourcing or contracting out to private entities certain services has dominated state and local government privatization efforts, representing perhaps 80 percent or more of privatization efforts. In more recent years, local governments such as Indianapolis, Cleveland and Philadelphia have pioneered the use of public-private competition for some services, and a handful of states have also embraced the idea. With this approach, government units submit bids and compete directly with private entities for the opportunity to provide a necessary government service. The approach accomplishes efficiency goals for the affected agency by forcing government to compete with the private sector. However, instead of mandating that the service be outsourced to the private sector, the choice is left to free

market principles with government being one potential supplier. This approach has the added benefits of potentially retaining public employees, encouraging a culture of efficiency in the remaining government agencies, and serves as a check on possible private sector corruption or collusion (Auger, 1999).

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